Sweating the Small Stuff:
Demand for Low Deductibles in Homeowners Insurance
Justin Sydnor
This Draft: July, 2006
Abstract
How much do individuals pay to insure against moderate losses? To address this question I study a new homeowners-insurance data set on individual deductible choice. Even though lower deductibles require sharply higher yearly premiums, 83% of customers paid for a deductible lower than the maximum available of $1000. The prototypical homeowner paid $100 to reduce the deductible to $500, yet with claim rates under 5% this additional coverage was worth less than $25 in expectation. Those insured with the company for longer were more likely to hold low deductibles, which can be plausibly explained by consumer inertia. Even among new customers, however, 61% chose a lower deductible, typically paying 400-500% of what that marginal insurance was worth in expectation. Using conservative assumptions, I find that the standard model of decision making under risk requires triple-digit coefficients of relative risk aversion to explain these choices. Such measures are inconsistent with estimates from studies of lifecycle-consumption and labor-supply behavior and imply implausible risk aversion over large-stakes gambles. In contrast, applying a variant of prospect theory with existing parameter estimates to insurance purchases fits well with the observed deductible choices. I also discuss other possible explanations for the extreme risk aversion observed.